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How Dodd–Frank Mandated Disclosures Harm, Rather than Protect, Investors

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Title XV of the Dodd–Frank Wall Street Reform and Consumer Protection Act[1] contains three provisions requiring public companies to report in their disclosure documents with respect to conflict minerals, mine safety, and resource extraction. In addition, Dodd-Frank Title IX Section 953(b) requires disclosure of the ratio between a company's CEO pay and the median pay of all other employees. The primary purpose of these requirements is to further political objectives. They are unrelated to the purpose of the securities laws and the mission of the Securities and Exchange Commission (SEC).

Severing Disclosure from Valuation Is a Bad Idea

The SEC defines its mission as "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[2] The statutory charge to the SEC is:

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[3]

The politically motivated requirements in Title XV distract, or in the case of the proposals for new disclosure requirements would distract, the SEC from its mission. Moreover, the requirements do nothing to further the securities laws' purpose of protecting shareholders or providing them with information that is material to their investment decisions. Shareholders, when presented with an opportunity to vote on whether to require such disclosure, have usually voted not to do so.[4]

These requirements impose unwarranted costs on issuers that reduce the return on shareholder investments.[5] The SEC estimates that the conflict minerals, mine safety, resource extraction, and CEO pay-ratio requirements combined will have initial compliance costs of approximately $5 billion, and ongoing costs of $1.5 billion annually. (See the discussion of each rule below for more detailed information about costs and citations.) Furthermore, by adding to already voluminous disclosure requirements, they tend to make it more difficult for investors to find material information in disclosure documents. By obfuscating rather than informing, these requirements can be expected to actually harm investors.[6]

Once the connection between SEC-mandated disclosure and investment valuation is severed, the potential disclosure requirements that may be imposed on public corporations are virtually limitless. These mandates increase costs and harm the ability of companies to innovate, grow, and create jobs. They reduce the return to investors. They therefore harm rather than protect investors.

This paper, in its entirety, can be found at
http://report.heritage.org/ib4526

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The Purpose of Securities Disclosure Laws

The primary purpose of securities law is to deter and punish fraud.[7] Fraud is the misrepresentation of material facts or the misleading omission of material facts for the purpose of inducing another to act, or to refrain from action, in reliance upon the misrepresentation or omission. The second purpose of securities laws is to foster disclosure by firms that sell securities to investors of material facts about the company needed to make informed investment decisions.[8] Appropriate mandatory disclosure requirements can promote capital formation, the efficient allocation of capital and the maintenance of a robust, public, and liquid secondary market for securities.[9] The reasons for this include (1) that the issuer is in the best position to accurately and cost-effectively produce information about the issuer;[10] (2) that information disclosure promotes better allocation of scarce capital resources or has other positive externalities;[11] (3) that the cost of capital may decline because investors will demand a lower risk premium;[12] (4) that disclosure makes it easier for shareholders to monitor management;[13] and (5) that disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.[14]

The conflict minerals, mine safety, resource extraction, and CEO pay-ratio disclosure requirements do nothing to further any aspect of the SEC mission or the underlying purpose of the securities laws. They neither protect investors from fraud nor improve investors' ability to value their investments. They neither facilitate capital formation, nor fair, orderly, and efficient markets. And the proposed political spending and gender-pay-ratio disclosure requirements share these defects. All of these provisions, however, increase firms' costs and reduce shareholder returns and make it more difficult for investors to find the information in disclosure documents that is material to their investment decisions. They harm rather than protect shareholders.

Conflict Minerals from the Democratic Republic of the Congo

In compliance with Dodd–Frank Section 1502, the 93-page SEC final conflict-minerals rule[15] requires any issuer for which conflict minerals[16] are necessary to the functionality or production of a product manufactured, or contracted to be manufactured, by that issuer to disclose in the body of its annual report whether its conflict minerals originated in the Democratic Republic of the Congo (DRC) or an adjoining country. If so, that issuer is required to furnish a separate report as an exhibit to its annual report that includes a description of the measures taken by the issuer to exercise due diligence on the source and chain of custody of its conflict minerals. These due diligence measures would include an independent private-sector audit of the issuer's report conducted in accordance with standards established by the Comptroller General of the United States. There are additional requirements. In its economic analysis in the final rule, the SEC estimated that the initial cost of compliance with the conflict minerals rule "is between approximately $3 billion to $4 billion, while the annual cost of ongoing compliance will be between $207 million and $609 million."[17]

On April 14, 2014, the United States Court of Appeals for the District of Columbia Circuit issued a decision in *National Association of Manufacturers v. SEC* finding that provisions in the rule violated the First Amendment to the extent they required a company to state that its products have not been found to be DRC conflict-free.[18] Accordingly, the rule has been partially stayed by the SEC.[19] In general, however, companies remain subject to the conflict-minerals disclosure regime.[20] The case was reheard and the decision was reaffirmed on August 18, 2015. On February 22, 2016, the Supreme Court granted the SEC's request for an extension of time to file a petition for a *writ of certiorari* to April 7, 2016.[21]

There is strong reason to doubt whether the provision is even helping to achieve its policy objective. The Government Accountability Office (GAO) found that "[c]ompany filings indicate companies exercised due diligence but most were unable to determine whether or not conflict minerals used came from covered countries, or whether they financed or benefited armed groups."[22] Furthermore, a recent empirical analysis found that "[i]nstead of reducing violence, the evidence here indicates the policies increased the incidents in which armed groups looted civilians and committed violence against them."[23] This is because Dodd–Frank created an incentive for armed groups to find alternative sources of revenue. They moved away from conflict minerals to unregulated sources of mineral revenue or to violent looting of civilians.

Mining Safety

In compliance with Dodd–Frank Section 1503, the 25-page SEC final mining safety rule [24] requires issuers that are operators of a mine to disclose information regarding specified health and safety violations, orders, citations, legal actions, and mining-related fatalities. Much of this information must be reported in a different format to the Mine Safety and Health Administration. The SEC estimates that approximately 100 companies will be affected and that compliance with the rule will involve 5,775 hours of company personnel time and approximately $1.1 million for the services of outside professionals.[25] Valuing the internal hours at a conservative $100 per hour (fully burdened), that would amount to $577,500 cost for internal personnel time for a total cost of approximately $1.7 million annually or $17,000 per issuer.

Resource Extraction

In compliance with Dodd–Frank Section 1504, the 55-page SEC final resource-extraction rule [26] requires resource-extraction issuers to disclose information relating to any payment made by the issuer to a foreign government (including companies owned by a foreign government) or the U.S. federal government for the purpose of the commercial development of oil, natural gas, or minerals. This information must disclose all payments including taxes, royalties, fees, production entitlements, bonuses, and other payments. In its economic analysis in the final rule, the SEC estimated that the ongoing compliance costs of the rule would be in the range of $173 million to $385 million annually.[27]

CEO Pay-Ratio Disclosure

In compliance with Title IX Section 953(b), the 85-page SEC final CEO pay-ratio disclosure rule[28] requires disclosure of the median of the annual total compensation for all employees of a company (excluding the CEO but including all foreign employees); the annual total compensation for the company's CEO; and the ratio of the median of the annual total compensation for all employees to the annual total compensation for the CEO. The rule exempts smaller reporting companies, emerging growth companies, and some other issuers from the requirements. The SEC estimates that 3,571 companies will be subject to the rule, that the total initial cost of compliance for all 3,571 registrants affected by the rule will be approximately $1.3 billion, and that ongoing compliance costs will be approximately $526 million per year.[29]

Efforts to Increase Politically Motivated Disclosure Requirements

The Dodd–Frank provisions are part of a continuing trend of using the securities laws to mandate disclosures that are not material to assessing the expected return from investing in a company (that is, its valuation) to further political objectives. For example, there is a major effort underway to pressure the SEC into issuing a rule requiring disclosure of corporate "political spending."[30] The campaign promoting this rulemaking has generated over one million comments to the SEC.[31] The information disclosed in compliance with this rule would not be used by investors to assess the value of their investments, but by activists to pressure corporation management with respect to political issues. Issuance of such a rule has been temporarily barred by Congress.[32]

Legislation has also been introduced in Congress to require both disclosure and a shareholder vote before public corporations can make political expenditures, including independent expenditures, or give money to a trade association for certain purposes. Spending made in contravention of the rules set forth in the legislation would give rise to joint and several liability by a corporation's officers and directors equal to treble the amount of the amount spent.[33] The requirements would not apply to private corporations, labor unions, or tax-exempt organizations. There is also a recent petition that asks the SEC to require public companies to disclosure "gender pay ratios."[34]

Conclusion

The politically motivated conflict minerals, mine safety, resource extraction, and CEO pay-ratio disclosure requirements in Dodd–Frank harm rather than protect investors, and reduce firms' ability to innovate, grow, and create jobs. They should be repealed.

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Endnotes

1. Public Law 111–203, July 21, 2010.
2. U.S. Securities and Exchange Commission, "About: What We Do–Introduction," http://www.sec.gov/about/whatwedo.shtml (accessed March 4, 2016).
3. See §3(f) of the Securities Exchange Act of 1934 and §2(b) of the Securities Act of 1933.
4. The Conference Board, "Corporate Political Spending: Shareholder Activity," https://www.conference-board.org/politicalspending/index.cfm?id=6256 (accessed March 4, 2016), and As You Sow, "Proxy Preview," 2014, http://www.asyousow.org/wp-content/uploads/2014/03/ProxyPreview2014.pdf?width=100 (accessed March 4, 2016).
5. For example, the U.S. Chamber of Commerce estimates, based on survey data, that the CEO pay-disclosure-rule compliance costs $711 million annually, substantially more than the SEC estimate. See Ike Brannon, "The Egregious Costs of the SEC's Pay-Ratio Disclosure Rule," May 2014, http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Egregious-Cost-of-Pay-Ratio-5.14.pdf (accessed March 4, 2016). The SEC estimated that the initial cost of compliance with the conflict-minerals rule "is between approximately $3 billion to $4 billion, while the annual cost of ongoing compliance will be between $207 million and $609 million." See "Conflict Minerals," Final Rule, *Federal Register*, Vol. 77, No. 177 (September 12, 2012), p. 56351, https://www.gpo.gov/fdsys/pkg/FR-2012-09-12/pdf/2012-21153.pdf (accessed March 4, 2016).
6. Troy A. Paredes, "Blinded by the Light: Information Overload and Its Consequences for Securities Regulation," *Washington University Law Quarterly*, Vol. 81 (2003), pp. 417–485, and Commissioner Troy A. Paredes, "Remarks at The SEC Speaks in 2013," Securities and Exchange Commission, February 22, 2013, http://www.sec.gov/News/Speech/Detail/Speech/1365171492408#.Ut2WJbROmM8 (accessed March 4, 2016). See also Keith F. Higgins, "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting," Securities and Exchange Commission, April 11, 2014, https://www.sec.gov/News/Speech/Detail/Speech/1370541479332 (accessed March 4, 2016), and Ernst & Young, "Now Is the Time to Address Disclosure Overload," *To the Point* No. 2012-18, June 21, 2012 http://www.ey.com/Publication/vwLUAssets/ToThePoint_BB2367_DisclosureOverload_21June2012/$FILE/TothePoint_BB2367_DisclosureOverload_21June2012.pdf (accessed March 4, 2016).
7. A transaction induced by fraud (misrepresentation) is not voluntary or welfare-enhancing, in that it would not be entered into in the absence of the fraud (or would be entered into at a different price). This principle has been recognized at common law since time immemorial and is recognized by virtually all political theorists. Securities fraud was illegal long before New Deal securities laws or blue sky laws were enacted. Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690–1860* (Cambridge University Press, 2002). See also Frank H. Easterbrook and Daniel R. Fischel, "Mandatory Disclosure and the Protection of Investors," *Virginia Law Review*, Vol. 70 (1984), p. 669; Gordon Walker, "Securities Regulation, Efficient Markets and Behavioural Finance: Reclaiming the Legal Genealogy," *Hong Kong Law Journal*, Vol. 36, No. 3 (2006); and Paul G. Mahoney, *Wasting a Crisis: Why Securities Regulation Fails* (Chicago: University Of Chicago Press, 2015).
8. For a general introduction, see Richard A. Posner, "Financial Markets," in *Economic Analysis of the Law*, 9th ed. (Wolters Kluwer Law & Business, 2014), and Joel Seligman, "The Corporate Disclosure Debate," in *The SEC and the Future of Finance* (Prager: 1985).
9. Robert A. Prentice, "The Economic Value of Securities Regulation," *Cardozo Law Review*, Vol. 28, No. 1 (2006), pp. 333–389; Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review*, Vol. 48 (2001), pp. 781–855; and Luca Enriques and Sergio Gilotta, "Disclosure and Financial Market Regulation," Social Science Research Network, April 11, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423768 (accessed March 4, 2016).
10. Marcel Kahan, "Securities Laws and the Social Cost of "Inaccurate" Stock Prices," *Duke Law Journal*, Vol. 41, No. 5, (1992), pp. 977–1044; John C. Coffee Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System," *Virginia Law Review*, Vol. 70 (1984), pp. 717–753; and Joel Seligman, "The Historical Need for a Mandatory Corporate Disclosure System," *Journal of Corporation Law*, Vol. 9, No. 1 (1983), p. 1.
11. Jeffrey Wurgler, "Financial Markets and the Allocation of Capital," *Journal of Financial Economics*, Vol. 58, No. 187 (2000); R. David Mclean, Tianyu Zhang, and Mengxin Zhao, "Why Does the Law Matter? Investor Protection and its Effects on Investment, Finance, and Growth," *The Journal of Finance*, Vol. 67, No. 1, pp. 313–350 (2012); Ronald A. Dye, "Mandatory Versus Voluntary Disclosures: The Cases of Financial and Real Externalities," *The Accounting Review*, Vol. 65, No. 1 (1990), pp. 1–24; Brian J. Bushee and Christian Leuz, "Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board," *Journal of Accounting and Economics*, Vol. 39, No. 2 (2005), pp. 233–264; Joseph A. Franco, "Why Antifraud Provisions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure," *Columbia Business Law Review*, Vol. 2002, No. 2, pp. 223–362; Paul M. Healy and Krishna G. Palepu, "Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature," *Journal of Accounting and Economics*, Vol. 31 (2001), pp. 405–440; and Anat R. Admati and Paul C. Pfleiderer, "Forcing Firms to Talk: Financial Disclosure Regulation and Externalities," *The Review of Financial Studies*, Vol. 13, No. 3 (Fall 200), pp. 479–519, https://faculty-gsb.stanford.edu/admati/documents/Forcingfirmstotalk_research.pdf (accessed March 4, 2016).
12. Christine A. Botosan, "Evidence that Greater Disclosure Lowers the Cost of Equity Capital," *Journal of Applied Corporate Finance*, Vol. 12, No. 4 (2000), pp, 60–69, and Charles P. Himmelberg, R. Glenn Hubbard, and Inessa Love, "Investor Protection, Ownership, and the Cost of Capital," Social Science Research Network, April 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303969 (accessed March 4, 2016).

13. The interests of shareholders and management are often not coincident and may conflict to a considerable degree. This is often described as the agent-principal problem, or collective-action problem, and is significant in larger firms where ownership and management of the firm are separate. Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Vol. 3, No. 4 (1976); Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems," *University of Chicago Law Review*, Vol. 62, No. 3 (1995), pp. 1047–1112; and Merritt B. Fox, "Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment," *Virginia Law Review*, Vol. 85, No. 7 (1999), pp. 1335–1419.
14. Requiring certain written affirmative representations in public disclosure documents deters fraud because proving fraud becomes easier if the public, written representations are later found by a trier of fact to be inconsistent with the facts.
15. "Conflict Minerals," Final Rule, *Federal Register*, pp. 56274–56365. See also Securities and Exchange Commission, "Dodd-Frank Wall Street Reform and Consumer Protection Act Frequently Asked Questions: Conflict Minerals," https://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm (accessed March 4, 2016).
16. The term conflict mineral means:

    (i) Columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives, which are limited to tantalum, tin, and tungsten, unless the Secretary of State determines that additional derivatives are financing conflict in the Democratic Republic of the Congo or an adjoining country; or

    (ii) Any other mineral or its derivatives determined by the Secretary of State to be financing conflict in the Democratic Republic of the Congo or an adjoining country.

    SEC, "Form SD, Specialized Disclosure Report," Section 1 Conflict Minerals Disclosure, Item 1.01 Conflict Minerals Disclosure and Report, section (d)(3), https://www.sec.gov/about/forms/formsd.pdf (accessed March 4, 2016).
17. "Conflict Minerals," Final Rule, *Federal Register*, p. 56351.
18. For a procedural history and links to case documents, see U.S. Chamber of Commerce, *NAM, Chamber of Commerce, and BRT v. U.S. Securities and Exchange Commission (SEC)*, http://www.chamberlitigation.com/nam-chamber-commerce-and-brt-v-us-securities-and-exchange-commission-sec (accessed March 4, 2016).
19. Securities Exchange Act of 1934, Order Issuing Stay, May 2, 2014, https://www.sec.gov/rules/other/2014/34-72079.pdf (accessed March 4, 2016).
20. Keith F. Higgins, "Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule," Securities and Exchange Commission, April 29, 2014, https://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541681994 (accessed March 4, 2016).
21. *Securities and Exchange Commission v. National Association of Manufacturers et al.*, docketed January 29, 2016, http://www.supremecourt.gov/search.aspx?filename=/docketfiles/15a792.htm (accessed March 4, 2016).
22. Government Accountability Office, "SEC Conflict Minerals Rule: Initial Disclosures Indicate Most Companies Were Unable to Determine the Source of Their Conflict Minerals," GAO–15–561, August 2015, p. 24, http://www.gao.gov/assets/680/672051.pdf (accessed March 4, 2016).
23. Dominic P. Parker and Bryan Vadheim, "Resource Cursed or Policy Cursed? U.S. Regulation of Conflict Minerals and the Rise of Violence in the Congo," University of Wisconsin, November 24, 2015, p. 31, http://aae.wisc.edu/dparker5/papers/DRCConflictWP2015.pdf (accessed March 4, 2016).
24. "Mine Safety Disclosure," Final Rule, *Federal Register*, Vol. 76, No. 249 (December 28, 2011), pp. 81762–81785, https://www.gpo.gov/fdsys/pkg/FR-2011-12-28/pdf/2011-33148.pdf (accessed March 4, 2016).
25. Ibid., p. 81778.
26. "Disclosure of Payments by Resource Extraction Issuers," Final Rule, *Federal Register*, Vol. 77, No. 177 (September 12, 2012), pp. 56365–56419, https://www.gpo.gov/fdsys/pkg/FR-2012-09-12/pdf/2012-21155.pdf (accessed March 4, 2016). See also Securities and Exchange Commission, "Dodd-Frank Wall Street Reform and Consumer Protection Act Frequently Asked Questions: Disclosure of Payments by Resource Extraction Issuers," May 30, 2013, https://www.sec.gov/divisions/corpfin/guidance/resourceextraction-faq.htm (accessed March 4, 2016).
27. "Disclosure of Payments by Resource Extraction Issuers," Final Rule, *Federal Register*, pp. 56410–56411.
28. "Pay Ratio Disclosure," Final Rule, *Federal Register*, Vol. 80, No. 159 (August 18, 2015), pp. 50104–50187, https://www.gpo.gov/fdsys/pkg/FR-2015-08-18/pdf/2015-19600.pdf (accessed March 4, 2016).
29. Ibid., p. 50161.
30. Dave Michaels, "Democrats Pressure SEC to Force Disclosure of Political Spending," Bloomberg, August 31, 2015, http://www.bloomberg.com/politics/articles/2015-08-31/democrats-pressure-sec-to-force-disclosure-of-political-spending (accessed March 4, 2016), and Congressional letter to SEC Chair Mary Jo White, December 22, 2015, signed by 94 Senators and Representatives, http://www.menendez.senate.gov/imo/media/doc/Letter%20to%20SEC%20on%20omnibus%20provision%202015-12-22%20FINAL1.pdf (accessed March 4, 2016).
31. "Petition for Rulemaking on Disclosure by Public Companies of Corporate Resources Used for Political Activities," File No. 4-637-2, April 15, 2014, https://www.sec.gov/rules/petitions/2014/petn4-637-2.pdf (accessed March 4, 2016); and Securities and Exchange Commission, "Comments on Rulemaking Petition: Petition to Require Public Companies to Disclose to Shareholders the Use of Corporate Resources for Political Activities," File No. 4-637, https://www.sec.gov/comments/4-637/4-637.shtml (accessed March 4, 2016).

32. Consolidated Appropriations Act, 2016, Public Law No: 114–113, December 18, 2015, Section 707, Title VII, Division O. ("None of the funds made available by any division of this Act shall be used by the Securities and Exchange Commission to finalize, issue, or implement any rule, regulation, or order regarding the disclosure of political contributions, contributions to tax exempt organizations, or dues paid to trade associations.") This act governs spending through the end of FY 2016, which ends September 30, 2016.
33. The Shareholder Protection Act of 2015, S. 214, H.R. 446, 114th Congress.
34. "Request for rulemaking to require public companies to disclose gender pay ratios on an annual basis, or in the alternative, to provide guidance to companies regarding voluntary reporting on pay equity to their investors," submitted by PAX Ellevate Management LLC, File No.4-696, February 1, 2016, https://www.sec.gov/rules/petitions/2016/petn4-696.pdf (accessed March 4, 2016).